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April 14, 2003

COMMENT

Via E-Mail (Secretary@cftc.gov)

Ms. Jean A. Webb
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Performance Data and Disclosure for Commodity Trading Advisors, 68 *Fed. Reg.* 12001 (March 13, 2003)

Dear Ms. Webb:

A CTA's clients and potential clients have a right to know how the CTA has performed in the past. The Commission's proposal is designed to benefit clients by giving them an accurate picture of that performance. In particular, the proposed change to the rate-of-return (ROR) calculation will enhance customer protection by ensuring that ROR measures a CTA's true performance and by reducing its ability to overstate positive returns, and the disclosure requirements will enhance customer protection by ensuring that clients understand the consequences of partially funding their accounts. NFA commends the Commission for this proposal, and we strongly support it.

NFA has already filed extensive comments on the issues raised in this release.¹ Therefore, we will keep our comments brief.

¹ See October 1, 1999 letter from Daniel J. Roth to Jean A. Webb responding to request for comments on Performance Data and Disclosure for Commodity Trading Advisors, 64 *Fed. Reg.* 41843 (August 2, 1999); September 15, 1998 letter from Daniel J. Roth to Jean A. Webb responding to request for comments on Performance Data and Disclosure for Commodity Trading Advisors and Commodity Pools, 63 *Fed. Reg.* 33297 (June 18, 1998). We refer you to those letters for a more in-depth discussion of the issues raised in the current release.

A. Rate of Return Computation

The Commission's release does an excellent job explaining the need to change the ROR computation and addressing the objections that have been raised in previous comment letters. A couple of points are worth reiterating, however.

As we have repeatedly stated, all similarly traded accounts should have the same ROR, regardless of the amount of funds on deposit with the FCM. The proposed method for calculating ROR accomplishes this objective. In contrast, the current actual funds method measures the CTA's clients' cash management strategies rather than the CTA's performance and overstates both positive and negative returns. The fully-funded subset method, while an accurate measure of performance, is not available to all CTAs. We also note that the proposed method results in the same ROR as the fully-funded subset method without imposing the same computational burdens.

Furthermore, the Commission's current rules and advisories disadvantage clients of CTAs with a mixture of fully-funded and partially-funded accounts by allowing those CTAs to choose between methods that yield different – and sometimes widely different – RORs. A CTA with a positive ROR can inflate that ROR by using the actual funds method instead of the fully-funded subset method, while the CTA is better off using the fully-funded subset method if it has losses. The Commission's proposal will require all CTAs to report ROR on a uniform basis, without the potentially distorted results or confusing multiplicity of tables allowed under the current regulations.

Some of the commenters who responded to the Commission's earlier releases were concerned that using nominal account size to calculate ROR would downplay the risk and the volatility in futures trading. Customer protection has always been NFA's number one priority, and NFA would be the first to object to the proposal if the commenters' concerns were justified. The truth is, however, that the proposed method of calculating ROR does not understate either volatility or risk. If an account is being traded as a \$250,000 account, it has the same volatility and risk as any other \$250,000 account in the same trading program regardless of the amount of funds on deposit.² In contrast, the current method overstates volatility by exaggerating profits and losses. It also creates widely divergent RORs for similarly traded accounts based solely on the client's different cash management policies and ignores the practical reality that both the CTA and the client consider the account size to be equivalent to the amount committed to trading, not the amount deposited for margin. The proposed method of calculating ROR presents a more accurate picture of volatility and has none of the other limitations inherent in the current method.

² Partial funding does not affect volatility or risk in either a theoretical or a practical sense. A 10 point move is a 10 point move and a \$5,000 gain or loss is a \$5,000 gain or loss regardless of whether it is 25% or 120% of the amount deposited at the FCM. Everyone in the same trading program has the same volatility and risk regardless of funding level. The funding level does, of course, affect the frequency and size of margin calls, and the disclosure requirements in the Commission's proposal ensure that the client will understand how margin calls are affected by its funding choices.

The proposed ROR calculation will eliminate the volatility distortions found in the actual funds method. We agree that the resulting performance figures will show less volatility, and they will also show lower RORs. In our experience, unwary customers are more likely to be lured into the futures markets by allusions to large profits than by information downplaying the volatility in these markets. In regard to CTAs in particular, we have seen far more abuses involving inflated RORs than artificially depressed volatility. The current method of calculating ROR feeds these abuses by inflating ROR for marginally profitable, as well as highly successful, CTAs. The proposed method will not.

B. Disclosure Requirements

The Commission's proposed disclosure requirements are designed to provide clients with more information so that they can make informed decisions about hiring particular CTAs to manage their futures accounts and what funding levels to use. The overall effect of the proposed amendments is to provide customers with a more accurate picture of the CTA's performance. Our specific comments follow.

NFA supports the Commission's proposals for documenting the nominal account size. These requirements will provide "discipline in the denominator" by assuring that the CTA and the client have agreed on the account size before the account is opened and begins trading. They will also provide NFA with important information regarding account sizes for purposes of auditing the CTA and reviewing its performance information. We also support the Commission's proposals requiring CTAs with partially funded accounts to provide clients with information about the effects of partial funding so that they can make informed decisions when funding their accounts.

NFA does not agree that the amount of funds deposited with the FCM is the appropriate measure for funds under management. A CTA manages all of the funds a client commits to its trading programs, even if they are located elsewhere for the time being. The CTA's decision to leverage accounts at a certain level rather than actively trading all available funds is itself a form of management. In addition, the amount a CTA actively trades may vary widely depending upon market conditions and the CTA's views on what the market is going to do. Since the amount of funds on deposit in a partially funded account is usually based on margin requirements, tying the amount under management to those funds ignores the differences in management style that are the very reason why a client chooses one CTA over another. Therefore, the Commission should define funds under management as the aggregate nominal account size.

Furthermore, the amount of funds under management, when measured by the total amount of funds committed to the CTA, provides useful information to clients. Although it is not infallible, large amounts of funds under management usually indicate that the advisor has gained the confidence of either a large number of clients or of several large institutional clients, both of which indicate a level of trust in the advisor.

Conversely, some people believe that performance begins to drop once a program gets too large, and those people would also benefit from knowing how much money has been committed to the advisor's trading program.

The amount of funds on deposit provides useful information to clients if – and only if – it is coupled with the amount of total funds committed to the CTA. By comparing these figures, the client can get some insight into the extent of notional funding in the CTA's accounts. Without the comparative information, however, the same amount of funds on deposit could represent a number of small clients with fully funded accounts or a number of large, institutional clients with partially funded accounts.

NFA supports the Commission's proposed rule defining net performance to include interest income on funds actually deposited with the client's FCM. Both the CTA's trading strategy and its performance can affect the amount of interest earned on the funds held by the FCM. Including interest earned on funds deposited with the FCM when calculating net performance is a longstanding industry practice, and the amount of interest earned on the cash equivalents held in clients' accounts does not usually have a material effect on overall performance when compared to other advisors. Therefore, NFA respectfully asks the Commission to adopt this portion of the rule as proposed.

NFA also supports the Commission's proposed requirement that the worst monthly and peak-to-valley draw-down amounts be disclosed on a composite basis rather than using the worst individual account. We are aware of comments in the press that providing this information on a composite basis does not give as strong a picture of the risk involved, but those comments misunderstand the purpose of draw-down information. Draw-down information is designed to show the historical volatility and risk of a particular trading program, not to highlight the general risk of investing in commodity futures. CFTC Regulation 1.55 and NFA Compliance Rule 2-30 are designed to highlight those general risks, and those requirements will not change. Given the differences in individual accounts based on factors beyond the CTA's control that affect performance (e.g., FCM commission rates, entry and exit points), however, composite information on draw-downs provides a more accurate picture of the historical volatility and risk in the CTA's trading program.

The Commission is proposing to incorporate certain aspects of the Commission's 1991 Advisory regarding intramonth additions and withdrawals in its rules, which would then supercede that Advisory. However, the Commission's proposal differs from the 1991 Advisory in several respects and may have some unintended results. We urge the Commission to carefully consider comments from the industry regarding the effect of these differences.

Finally, NFA asks the Commission to reconsider its proposals to require additional disclosures regarding draw-downs at the lowest funding level and range of RORs for closed accounts. These requirements provide clients with information overload and increase the burden on CTAs without providing a corresponding benefit.

C. Core Principle Alternative

The Commission also requested comments on whether it should adopt a core principles approach to performance disclosure. Certain types of disclosure are well suited to a core principles approach, but the method of determining ROR is not one of them.

NFA recognizes that the managed funds industry has asked the Commission to take a core principles approach regarding certain disclosure issues. We do not believe, however, that the industry's initiative encompasses the performance calculation. Instead, the industry has long advocated using a uniform calculation so that clients can compare the performance of different managers and funds more easily.

There are also advantages to using a uniform method of presentation, as provided by the capsule performance requirements. On the other hand, there may be room for a limited amount of flexibility in presenting capsule information other than ROR. In this instance, the current requirements could be a safe harbor, and any CTA that departs from those requirements would have to obtain prior approval from either NFA or the CFTC after showing that the departure provides the essence of the required information and is not misleading.

The industry does advocate eliminating many of the current restrictions on advertising and solicitation and replacing them with more of a core principles approach, and we support that initiative. The Commission has responded to these concerns in its rule proposal regarding registration exemptions, and we will provide comments in response to that release.³

D. Conclusion

NFA commends the Commission for proposing rule changes that will provide a more accurate picture of a CTA's performance. This proposal enhances customer protection and should be adopted.

If you have any questions concerning this letter, please contact me (312-781-1413, tsexton@nfa.futures.org) or Kathryn Camp (312-781-1393, kcamp@nfa.futures.org).

Respectfully submitted,

Thomas W. Sexton
Vice President and General Counsel

(kpc/Notional/Comment Letter-3)

³ See Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors, 68 *Fed. Reg.* 12622 (March 17, 2003).